Essays on Shariah Compliant Stocks

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Chapter 1. Introduction and Summary[1]

Islam restricts the ability of Muslims to invest in stocks. They can only invest in so-called *Shariah* compliant stocks. These stocks have to pass certain financial and non-financial screens to be considered Islamic. In a way, these stocks are given an Islamic label. This dissertation is about this Islamic label. Specifically, the main question I want to answer is whether an Islamic label for listed companies indicates that they are different from listed companies without such a label.

This question is interesting because Islamic finance (of which *Shariah* compliant stocks are a subset) has been growing double digits for the past 10 years and proponents of this industry argue that it is a better alternative for the current financial system. The argument goes that because Islam preaches avoiding debt and taking excessive risk, the recent financial crisis would have been prevented (or at least mitigated) if it were based on Islamic principles. This might very well be true, but in practice, Islamic finance tends to look very similar to conventional finance.

In this dissertation, I show that this similarity is even stronger for *Shariah* compliant stocks. In other words, an Islamic label for stocks is meaningless, at least financially. This does not mean the label is without value. Muslims might very much value investing in accordance with their faith as other ethically inclined investors value investing in socially responsible companies. What I argue is that Muslims should not expect additional financial benefits (nor penalties!) from investing in *Shariah* compliant stocks.

[1] This dissertation is a collection of separate essays. Thus, there is inevitably some repetition, mostly with regard to explaining the basics of Islamic finance. However, I leave these repetitive passages in the text for two reasons. First, I want the reader to be able to read the separate essays on a stand-alone basis without having to necessarily consult other sections of the dissertation. Second, it helps the readability of the separate essays. Despite being separate essays, the reader will notice a clear unifying theme, namely, the effect of an Islamic label on various characteristics of listed companies. I try to sort the essays such that the next essay follows naturally from the previous one.
Some other relevant notes: (i) The Arabic terms used in this dissertation are based on classical Arabic, which is conventional in research on Islamic finance. (ii) Throughout this dissertation, the following words are used interchangeably: "stocks", "equities", and "shares"; "debt" and "leverage"; "firm" and "company"; "essay" and "study"; "*halal*", "Islamic", and "*Shariah* compliant"; "certification" and "certificate". (iii) I use "we" for self-reference in chapters based on papers authored with others and "I" for papers authored only by myself. (iv) When I refer to rows and columns in the tables, the first row (column) is the one that contains data.

This argument is based on the findings of several studies, which are included in this dissertation as chapters.[2] In Chapter 2, I briefly describe the Islamic finance industry and show that Islamic finance in general and *Shariah* compliant stock investing in particular have indeed shown stellar growth, the latter 28% per year in the past 17 years. The literature indicates that for Islamic finance in general, growth has been driven mainly by the size, growth, wealth, and purchasing power of the Muslim population. For *Shariah* compliant stock investing in particular, there is much less literature, but I argue that literature on Socially Responsible Investing (SRI) might provide some insight.

To do this, I first show that SRI and *Shariah* compliant stock investing are related. Namely, if SRI is defined using the definition of Eurosif (2014), *Shariah* compliant stock investing can be seen as a subset of SRI. Specifically, SRI that excludes certain companies/sectors from its investment universe based on ethical/moral grounds. *Shariah* compliant stock investing does exactly this, although what is morally unacceptable is sometimes different from SRI (for example, companies that produce or sell pork).

Given their relatedness, I review the literature on the growth of both SRI and *Shariah* compliant stock investing. This growth is usually measured by the growth of SRI funds and funds that invest in *Shariah* compliant stocks. From the literature, I gather that the factors that explain this growth can be classified in micro factors and macro factors.

Regarding the micro factors, the growth of SRI seems to be driven by these funds' returns, age, size, riskiness, and management fees (Renneboog et al., 2011) and this does not seem to differ for Islamic funds (Marzuki and Worthington, 2011). Overall, both types of funds that have higher past returns and are younger seem to attract more money. Fees, size, and riskiness also affect growth of both type of funds, but it is less clear whether the effect is in the same direction.

[2] More specifically, Chapters 4, 5, 6, and 7 are separate studies, Chapters 2 and 3 are introductory background chapters, and Chapter 1 summarizes and concludes. Chapters 4 and 7 have been published as Hayat and Kraeussl (2011) and Hayat et al. (2013) in *Emerging Markets Review* and *Journal of Business Ethics*, respectively. Chapter 5 is a VU University Amsterdam and Saudi Spanish Center for Islamic Economics and Finance (SCIEF) working paper and is joint work with Celia de Anca. Finally, Chapter 6 is a VU University Amsterdam working paper.

Regarding macro factors, the growth of SRI seems to be driven by differences between countries in culture, the size of the pension fund sector, economic openness, and the tax environment (Scholtens, 2005; Scholtens and Dam, 2007; and Scholtens and Sievänen, 2013). Specifically, countries with (i) a culture of low masculinity and high uncertainty avoidance (see Hofstede, 1980 and 1991), (ii) a large pension fund sector, and (iii) an open economy (in terms of trade) tend to engage more in SRI than countries without these characteristics. This might also hold for *Shariah* compliant stock investing. As a very rough indication, the three countries where most Islamic funds are domiciled do seem to have these characteristics. However, more data and proper statistical analysis is needed to conclude that these factors have actually influenced the growth of *Shariah* compliant stock investing in these countries. This is an interesting topic for further research.

Chapter 3 compares risk and returns of the *Shariah* compliant stock market to the conventional stock market. Specifically, it analyzes the return distributions of Islamic and conventional stock indices and shows that they are similar. Broadly speaking, *Shariah* compliant stocks outperform conventional stocks during a bear market and underperform during a bull market, but do not perform significantly differently in the long run, nor do they appear less risky than conventional stocks. This is still good news for Muslims because it means that they do not have to give up return or incur extra risk for investing in accordance with their own faith.

Unfortunately, the same cannot be said of funds that actually invest in *Shariah* compliant stocks (so called Islamic Equity Funds). Namely, Chapter 4 analyzes the performance of these Islamic Equity Funds (IEFs) and shows that they do not outperform either conventional or *Shariah* compliant stock indices (alternatively called Islamic indices). During the 2008/2009 financial crisis, these IEFs even significantly underperform the Islamic as well as conventional stock market. The reason for this underperformance seems to be that IEF managers try to time the market, but as a consequence reduce their returns because they fail. This is unfortunate because mutual funds typically charge fees (on average 2% of the assets under management) for managing their clients' funds and justify these fees by offering a higher return than a broad market index. That mutual funds in general cannot beat the market is well established empirically. I find that this is no different for Islamic equity funds.

Despite the fact that neither Islamic indices nor IEFs outperform conventional indices, Muslims may still put a monetary on value investing in accordance with their faith. One way to test this is to analyze how stocks react when they get an Islamic label and when this label is removed. If Muslims actually value an Islamic label, stocks that get such a label can be expected to appreciate in value since there is extra demand for these stocks and vice versa when this Islamic label is removed.

That is what I analyze in Chapter 5. However, I find that stocks do not react when they get an Islamic label or when this label is removed. Specifically, I analyze additions to and deletions from an Islamic index, namely the FTSE *Shariah* Global Equity Index (FTSE Islamic). It appears that, after correcting for other factors that explain stock returns (such as the market return, a value factor, a size factor, and a momentum factor), stocks that are added to (deleted from) the FTSE Islamic do not experience abnormally high (low) returns on that day, nor over the long term. Thus, investors do not seem to value an Islamic label, at least not enough to make stock prices move.[3]

Chapter 5 also shows that it is not strange that investors do not price an Islamic label. Namely, it shows that there are no significant differences in risk, profitability, or investor awareness of stocks in the period before and after they get (or lose) an Islamic label. If there were significant differences in risk, profitability, or investor awareness, this might indicate the Islamic label signals information about these characteristics.

But perhaps an Islamic label indicates other positive properties that are not directly apparent. An important one is good corporate governance, because recent research directly links governance to leverage (e.g., Arping and Sautner, 2010). Specifically, this research argues that leverage and governance act as substitutes in mitigating agency problems. In this view, firms with low governance quality take on debt to mitigate agency problems (such as excessive perks of CEOs

[3] Alternatively, the absence of a reaction to an Islamic label means that there are not enough funds investing in this Islamic index to make its constituent stocks react.

and unnecessary but empire-building acquisitions). If this is the case, the opposite should also hold, i.e., firms with lower debt can be expected to have better quality governance.

Since the Islamic label indicates low debt, it might indirectly also indicate good governance. Indeed, the Islamic label is sometimes marketed by its sellers (such as FTSE and Dow Jones) as SRI. However, as explained before, *Shariah* compliant stock investing only resembles SRI in a narrow sense. Both exclude certain sectors and companies based on ethical/moral grounds. However, where SRI usually includes Environmental, Social, and Governance (ESG) criteria, the Islamic label does not explicitly consider these ESG criteria in its screening process. Still, the marketing of the Islamic label as SRI might be partially justified, at least in terms of governance (the G in ESG).

However, Chapter 6 shows that this is not the case. Chapter 6 analyzes the effect of an Islamic label on corporate governance. It shows that, after controlling for other determinants, the Islamic label does not significantly affect overall governance quality. Thus, an Islamic label does not indicate good governance.[4]

Although an Islamic label does not seem to signal anything financially meaningful, nor say anything about good governance, Chapter 7 shows that it is costly to get this label (which I call a *halal* certification in this chapter). For a common Islamic financial product (an Islamic equity fund), I estimate that these costs are comparable to getting a credit rating for bonds. Chapter 7 also shows that the market for these *halal* certifications is dominated by just a few Islamic scholars. The elite scholars of this group earn substantial fees (estimated at USD 4.5 million per year) for giving these certifications and thus have a clear incentive to be excessively lenient in giving them.

Chapter 7 discusses some possible solutions to this problem. The best of these solutions is that a neutral nonprofit organization takes on the provision of all *halal* certifications, pays its *Shariah*

[4] The Islamic label does, however, positively affect governance quality as measured by the Bloomberg Corporate Governance Disclosure score. This relationship is quite robust to different specifications. However, I do not derive strong conclusions from this finding because the same Islamic label is insignificant in explaining my other three proxies for governance quality.

scholars fixed fees, and is funded collectively by the international Islamic finance community. Ideally, this organization should be domiciled in a country that is neutral, has excellent institutional quality, a well-developed financial sector, and an open culture.

The overall conclusion of this dissertation is that there is nothing really special about investing in *Shariah* compliant stocks. This is in contrast to previous research, which tends to be overly positive towards investing in these stocks. For example, it finds that *Shariah* compliant stocks are more resilient during crises (Bhatt and Sultan, 2012), are suitable for risk averse investors (Ho et al., 2014), and, in some cases, might even might be considered as a separate asset class (Dewandaru et al., 2014). The findings in this dissertation suggest these claims should be interpreted with caution.

Furthermore, my research has five important implications that can improve the current situation for Muslim investors. First, investing in *Shariah* compliant stocks can increase the welfare of Muslims. Namely, it offers them a chance to invest in accordance with their faith without having to give up return or incur additional risk. A specific way to do this, for example, is by giving Muslims the opportunity to invest their pensions in a *Shariah* compliant way.

Second, potential Muslim investors should be explicitly made aware of the exposures inherent to *Shariah* compliant stock investing, for example, the high exposures Islamic portfolios have to the Healthcare, Technology, and Oil and gas sectors, but also, more subtly, exposures to growth stocks.

Third, if Muslims choose to invest in *Shariah* compliant stocks, they are better off investing in passive investments such as an Islamic ETF, rather than investing in Islamic Equity Funds. This is because the latter do not outperform the overall index, while they charge higher management fees than passive funds.

Fourth, a neutral non-profit organization should take over the current practice of *halal* certifications. This is because Muslim investors currently face an additional source of uncertainty not borne by conventional investors, namely, *Shariah* scholar uncertainty (the chance that

Shariah scholars change their mind on what exactly is considered *halal*). Such an organization should preferably be based in a neutral country with good institutional quality, a well-developed financial sector, and an open culture. Based on institutional quality and financial sector development, Switzerland, Sweden, or the Netherlands seem good candidates since they score high on both these measures.

Finally, the Islamic label should explicitly incorporate ESG criteria into its screening process because the principles of Islam do explicitly call for business to be conducted in a way that considers environmental, social, and governance issues. Without inclusion of these criteria, the Islamic label runs the risk of becoming a marketing gimmick rather than an indication of ethical quality.